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International Economic & Energy Weekly

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21 June 1985

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International Economic & Energy Weekly [redacted] 25X1

21 June 1985

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Synopsis

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International Economic & Energy Weekly

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21 June 1985

Perspective

Brazil: Adjustment Progress in Jeopardy

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Brazil's transition from military to civilian rule is occurring at a crucial time for the country's economy. The new government's hopes for easing its huge debt burden suffered several setbacks early this year. In February, the IMF suspended support for Brazil because of the previous military government's failure to comply with monetary targets. Consequently, foreign banks postponed completion of a multiyear rescheduling of $45 billion in debts maturing over the next six years

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We believe the recent deterioration in Brazil's economic performance has dimmed prospects for a quick reconciliation with international creditors. Brazil's large trade surplus has dwindled this year largely because of shrinking US demand. Meanwhile, inflation surged to a record high of 280 percent at an annual rate in the first quarter. Lower inflation in April and May stems primarily from temporary price controls and, perhaps, some statistical manipulation Although we judge that economic performance is not of crisis proportions, it does highlight the continuing vulnerabilities in Brazil's economy. 25X1

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Implementing the thoroughgoing reforms needed to stabilize the economy is proving difficult for the new civilian administration of President Sarney. Since the government was installed in March, it has had to contend with rising demands by Brazilian interest groups and the general population for better living conditions. Labor sees opportunities to recoup some of the large real wage losses incurred in recent years. Unions have staged many strikes and work stoppages to demand major wage increases and shorter hours. Also, many left-of-center politicians in the new ruling coalition find themselves in position to influence policy for the first time in 21 years and are pushing an array of new publicly funded social programs. 25X1

Largely because Sarney is a relatively little known and inexperienced national leader with a small political base, it is difficult to predict the direction and content of the administration's future policies. We believe it is most likely that Brasilia will adopt additional adjustment measures to lessen domestic and external imbalances and gradually succeed in strengthening both its international financial position and its long-term prospects for sustained growth. On the downside, we believe there is some risk that the new government will succumb to the lure of populist policies aimed at rapid increases in economic growth and consumption. That option probably would lead to an acceleration of inflation, a renewed foreign exchange crisis, and a sharp economic downturn later in the 1980s. Brazil's responses to its economic challenges also will have major implications for financial prospects for the other Latin American countries struggling with debt problems. 25X1

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Brazil: Sarney's Difficult Economic Task [redacted] 25X1

President Jose Sarney's attempts to consolidate his position as Brazil's new national leader portend a more gradual economic stabilization effort than might have been expected under the highly popular Tancredo Neves. While publicly embracing Neves's commitment to slow Brazil's inflation, strengthen its external accounts, and reschedule its debts, Sarney is moving cautiously in the face of the often conflicting pressures from ideologically disparate groups within his administration and the Congress. With his as-yet-small independent political base, Sarney will not easily be able to deflect pressures to ease austerity—particularly if progress on inflation or dealings with foreign creditors lag. [redacted]

Sarney's Constraints

Sarney's room for maneuver in pushing stabilization is constrained by his tenuous political position. He is mistrusted by Neves's Brazilian Democratic Movement Party (PMDB)—the senior partner of the alliance that elected the Neves-Sarney ticket—because of his previous affiliation with military-backed political parties. Sarney's highest priority, [redacted] is to consolidate his standing with Neves's alliance. To do this, he has felt obliged to give the PMDB, including its large contingent of left-of-center members, a significant voice in economic policy. He has substantially increased the influence of Planning Minister Sayad, a favorite of the PMDB left of center, to rival that of the monetarist Finance Minister Dornelles, Neves's intended economic czar. In addition, Sarney has indicated he will seek approval for major decisions from the Brazilian Congress, in which the PMDB has the largest representation. [redacted]

Moreover, the relatively unknown President has little popular backing on which to draw for support of tough adjustment measures. According to the US Embassy, he is widely viewed as an accidental president. It is unlikely he will be able to fashion the sort of social pact among business, labor, and government that figured prominently in Neves's strategy to defuse inflation. [redacted] 25X1

An Early Cautious Approach

Sarney made few major economic policy pronouncements during his initial months in office, preferring to concentrate on political issues such as direct presidential elections and party reforms. As a result, the economic initiatives taken to date have not provided a clear statement of the administration's strategy or commitment to stabilization. Although the President supported the tough austerity measures announced by Dornelles in March—including a 10-percent cut in Treasury spending, a two-month halt in new federal lending, a freeze in government hiring, and a reinstitution of widespread price controls—his administration announced in May a $2.6 billion emergency social program, which had been proposed by Sayad. [redacted] 25X1

The new government also took a conciliatory position in its approach to labor relations. Last month, Sarney doubled the minimum salary that, although far less than what labor wanted, the US Embassy reports will provide a 6-percent real wage increase for lower pay scale Brazilian workers, the first in several years. Furthermore, Sarney reacted to a wave of strikes during April and May with promises to respect the right to strike and not to intervene in labor affairs so long as excessive violence is averted. Many workers won more frequent wage adjustments and shorter workweeks. [redacted] 25X1

Contributing to the tentativeness that so far has characterized the new government's economic policies have been the conflicting views of Sarney's two

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principal economic advisers, now struggling for preeminence in policymaking. Dornelles attaches top priority to a vigorous anti-inflation campaign while Sayad believes that social programs to help the poor are more urgent. For now, both wield considerable influence. The new emergency spending program is testimony to Sayad's important role in policy formulation. Dornelles [redacted] has lately impressed the new President with his competence and particularly his success in lowering Brazil's monthly inflation from 12.7 percent in March to less than 8 percent in April and May through price controls and monetary restraint. [redacted]

Prospect for Gradual Stabilization

In the face of the difficult economic decisions he will face in the coming months, we believe Sarney will uphold Neves's commitment to stabilization but probably will stretch it out over several years. The press has reported Sarney's personal conservative views and his appreciation of the potentially dangerous effects of inflation. We believe, nevertheless, he will be willing to compromise with the PMDB leadership over various social spending proposals and growth-oriented programs in order to maintain its political cooperation. [redacted]

[redacted]

The vigor of the new administration's economic stabilization campaign this year probably will depend partly on Dornelles' influence. [redacted] Dornelles will look increasingly to fiscal and monetary restraints to slow inflation and will attempt to use the results to persuade the IMF to renew its support and creditor banks to complete a multiyear debt rescheduling. In that regard, we believe a major task for Dornelles will be to marshal support for austerity from an increasingly assertive Congress. Because of pressures from the PMDB left, Dornelles probably will have to show some early success in controlling inflation and in negotiating favorable pacts with international creditors in order to maintain his key policy role. [redacted]

We believe Dornelles' policies stand a good chance of holding down 1985 inflation close to last year's 224-percent level without jeopardizing economic growth. Although the much smaller price increases of the past two months will probably not continue after price controls are eased in July, they may have some effect on inflationary expectations and will reduce the large inflation-indexed debt component of the public deficit. Also in our view: 25X1 25X1

- The administration should find enough support in Congress for further cuts in the nonindexed elements of the deficit.
- Private industry employers will resist labor demands for major real wage increases. 25X1
- A smaller trade surplus this year than last should make it easier for monetary authorities to contain money growth.

At the same time, we believe that the current recovery will be sustained sufficiently this year to permit 3- to 4-percent GDP growth. Although exports will not serve as a major engine of growth as they did in 1984, we expect a rise in domestic demand for manufactured goods and a good agricultural year [redacted] 25X1

After a slow start in the first quarter, the trade balance has been improving steadily as a result of the government's aggressive devaluations and increased export credit. Moreover, the subsiding value of the US dollar—to which the cruziero is tied—has enhanced Brazilian competitiveness in European and Japanese markets. Nevertheless, the economic slowdown in the United States, Brazil's largest market, will limit Brazil's trade prospects. On balance, we estimate that a $1 billion drop in industrial exports to $26 billion together with an equivalent rise in imports will net Brazil an $11 billion trade surplus in 1985. Although some $2 billion less than last year's total, it probably will cover the country's scheduled net interest payments. [redacted] 25X1 25X1 25X1 25X1 25X1

The Sarney administration, [redacted] will insist on small additional concessions from international creditors to distinguish its policies from those of the military regime and probably will conclude new agreements, in our view, only 25X1 25X1

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after long and tedious negotiations. The task before Brazil and the IMF of bridging their differences on inflation and public deficit targets will be especially difficult. While Dornelles insists that the IMF will have to accept more realistic targets if its relations with Brazil are to be restored, the Fund expects a more determined effort to complete tough adjustment measures than Brasilia has previously shown. The constructive meeting held in May between Dornelles and IMF Managing Director DeLarosiere and the personal bond that may have been established [redacted] may facilitate an eventual accord. [redacted] 25X1 25X1 25X1

[redacted] 25X1

Dornelles is satisfied with the basic multiyear debt rescheduling worked out by the military government with foreign banks, but will demand some additional small advantage for Brazil so that it can be packaged as a new and better Sarney administration agreement. The most contentious issues to be resolved probably will be the establishment of an acceptable monitoring mechanism for economic adjustment progress during the rescheduling period, [redacted] Foreign bankers have agreed to negotiate rescheduling terms concurrently with the IMF talks, but with the understanding that a signed IMF accord will be a prerequisite. [redacted] 25X1 25X1

Risk of Losing Control

We believe there is a small but potentially serious possibility that Sarney might stray from this balanced economic and social stabilization approach. [redacted] 25X1 Sarney may yield to the pressures of the left within the alliance in order to enhance his own political standing. Influential members of this group [redacted] advocate relaxation of restraints on monetary growth and public spending and a more confrontational stand against creditor banks. These policies could contribute to a leap in inflation to the 300- to 500-percent range, severe balance-of-payments deterioration, and a new international financial crisis. Alternatively, an effort by the new President to push a rigorous austerity program without regard to the social costs might antagonize both his PMDB backers and the public at large. This could precipitate a strong popular movement for early direct elections, rendering Sarney a lameduck president and an ineffectual national leader. [redacted] 25X1 25X1 25X1

[redacted] 25X1

Nigeria: Surviving Without the IMF

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Nigeria stands out among major LDC debtors for its refusal to accept an IMF-sponsored adjustment program. Although an agreement would substantially ease its cash-flow problems—servicing Nigeria's $23 billion external debt requires more than 40 percent of export earnings—the 18-month-old military government, led by Major General Buhari, has rejected certain IMF preconditions, including a devaluation. Instead, Lagos has adopted a unilateral program of economic survival that requires sharp reductions in government expenditures and imports. If the present regime is not overthrown, it probably can avoid coming to terms with the IMF for another 12 months if the oil market stabilizes. Nevertheless, the pressures of economic stagnation are likely to compel whoever rules in Lagos to seek an agreement before the end of 1986.

Negotiations With the IMF

Nigeria has faced a critical foreign payments problem for over four years. Since 1981, imports have been cut 50 percent, foreign exchange reserves have declined by more than 80 percent, and trade debt arrears have risen to about $9 billion. Nigeria's current cash-flow bind arises from three developments:

- Oil exports—more than 95 percent of foreign exchange earnings—fell from $25 billion in 1980 to about $11 billion in 1984.
- A repayment bulge on medium- and long-term debt incurred in the late 1970s is pushing amortization on this debt from less than $500 million in 1982 to a projected $3.5 billion in 1987.
- Fulfillment of an April 1984 agreement with commercial creditors to reschedule about $6 billion in arrears on uninsured trade debt will impose heavy short-term foreign exchange requirements.

With Nigeria's debt service ratio projected to rise from 40 percent in 1985 to more than 60 percent in 1987, an agreement with the IMF could provide timely relief by:

- Enabling Nigeria to borrow about $3 billion from the IMF and World Bank over a three-year period.
- Facilitating the rescheduling of Nigeria's medium- and long-term debt to commercial banks, for which an IMF agreement is generally a prerequisite.
- Allowing the rescheduling of guaranteed trade debt. Western export credit agencies—organized under the Paris Club—formally have refused to reschedule without an IMF agreement. 25X1

Negotiations between the Buhari government and the Fund have been deadlocked over Nigeria's rejection of the IMF's recommendation of a major devaluation of the naira, elimination of petroleum subsidies, and trade liberalization. The devaluation issue presents the greatest obstacle. With the black-market rate at about one-fourth the official rate of $1.11, the IMF has suggested a 60-percent devaluation to restore export competitiveness and induce import substitution. 25X1

Lagos argues that a large devaluation would do little to improve its foreign payments position because its major export—oil—is priced in dollars. Furthermore, development of new exports might take several years, while Nigeria's situation demands short-term assistance. Lagos also notes that its demand for imports, including food, is highly inelastic: Nigeria still would have to import about the same volume of goods even at much higher prices. Food consumption already is inadequate, and domestic production could not be increased rapidly. 25X1

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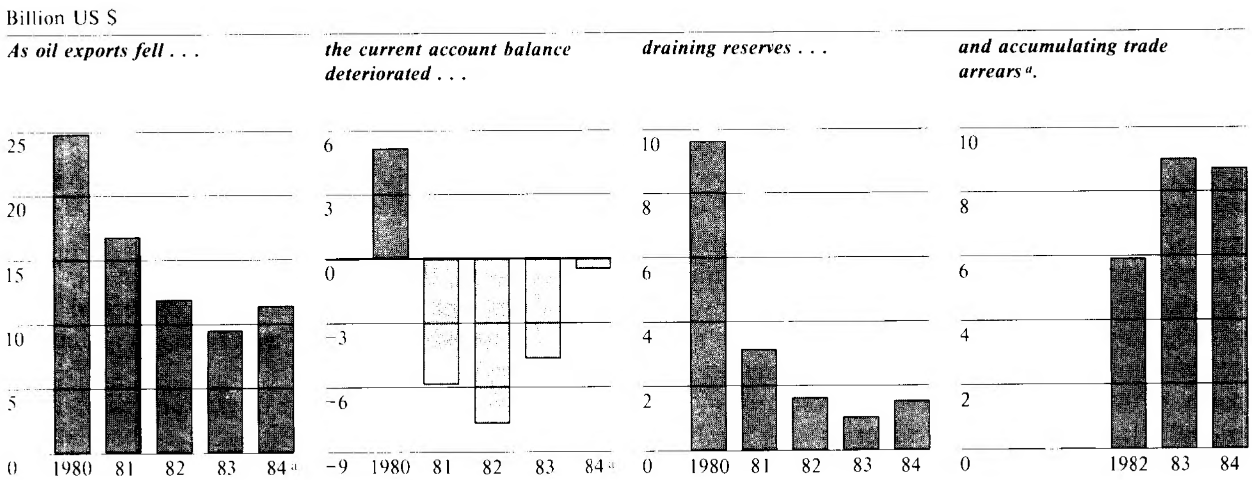
Nigeria's Financial Deterioration, 1980-84



[a] Estimated.

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These objections, however, are secondary to Buhari's fear of the destabilizing political effects of a major devaluation. Government spokesmen have consistently denounced the IMF program as a prescription for upheaval because it would sharply increase prices for food and other basic commodities. Buhari has stated, "We don't want to have . . . the riots that seem to signify the arrival of the IMF in most developing countries." [redacted]

Buhari's Economic Program

Contrary to the expectations of many Western bankers and economists, Nigeria has managed to survive since 1983 without an IMF program through a combination of economic austerity, gamesmanship with creditors, increased oil production, and, most recently, countertrade. The strategy, however, offers no prospect of renewed growth and merely places the economy in a holding pattern until the debt service peak in 1987, after which, Buhari claims, "the pressures will ease." The government's unspoken assumption is that key interest groups—such as the military, trade unions, and students—can endure economic stagnation more easily than the sharp and immediate price hikes that an IMF accord would require. [redacted] 25X1

The draconian austerity program implemented in 1984 reduced Nigeria's current account and budget deficits significantly, but at the cost of diminished economic activity. Through a stringent foreign exchange allocation system, Nigeria cut its import bill in half between 1981 and 1984. The import squeeze helped lower the current account deficit by 90 percent to less than $1 billion. This year the government replaced foreign exchange controls with an even stricter universal import licensing scheme, but we believe Nigeria will import about the same amount of goods as last year. [redacted] 25X1

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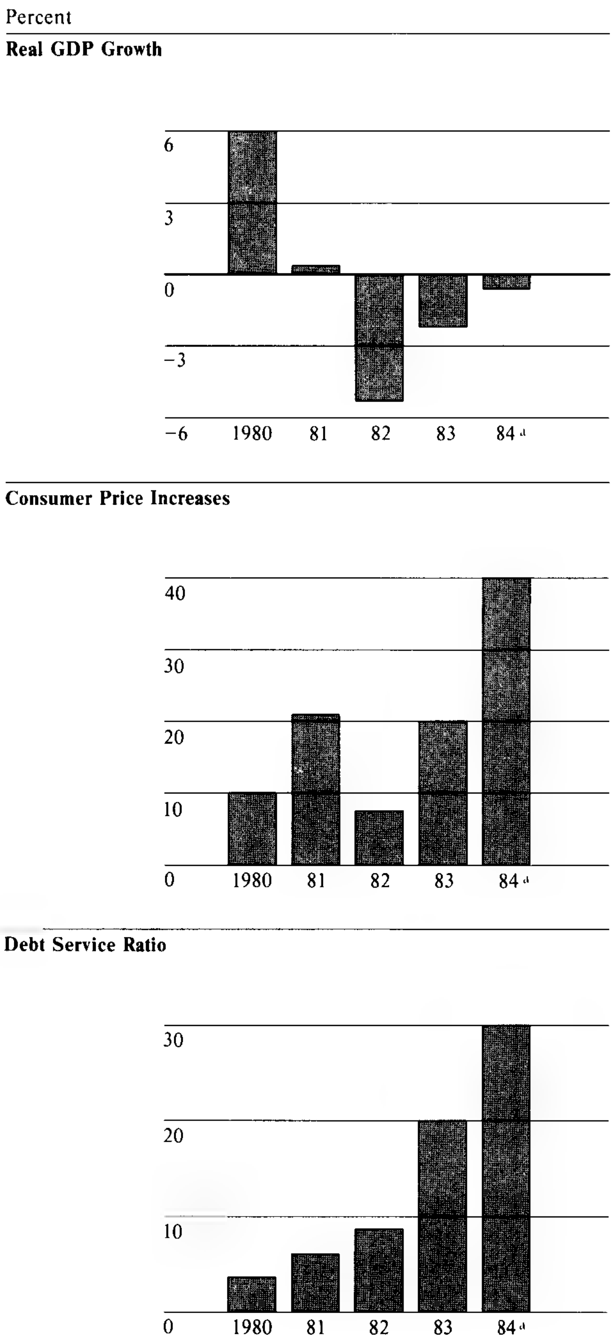
Nigeria: Economic Indicators, 1980-84



[a] Estimated.

[redacted]

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[redacted] 25X1 Nigeria's import strategy heavily favors basic commodities and agricultural inputs. Although the trade restrictions fueled overall inflation—consumer prices rose 40 percent in 1984—US Embassy reporting indicates that politically sensitive food prices have stabilized over the last 12 months. [redacted] 25X1

Despite a stagnation in revenues, Lagos halved its 1984 budget deficit to less than 5 percent of GDP through cuts in payroll costs, capital expenditures, and transfers to state governments. Although budget and trade policies have significantly slowed Nigeria's financial deterioration, they have also brought about a third straight year of negative economic growth. The IMF estimates that nonagricultural industries are operating at less than 40-percent capacity due to shortages in imported inputs and reduced demand. As a result, unemployment climbed steadily in 1984. [redacted] 25X1

Relations With Western Creditors

Buhari's go-it-alone strategy does not allow Nigeria to meet its debt obligations. Although Lagos thus far has honored its medium- and long-term debt on schedule, it has not serviced the short-term debt. According to the US Embassy, budgeting for 1985 debt service was based solely on projections of what Nigeria could afford, with arrears on trade debt receiving lowest priority. [redacted] 25X1

Nigeria has slipped far behind on its April 1984 pledge to reschedule $6 billion in uninsured trade arrears. Lagos has rescheduled only $329 million of these debts and regularly fails to meet its public commitments to trade creditors. Earlier this year the Central Bank promised to reschedule $2.2 billion in arrears by the end of June, but [redacted] 25X1 only $530 million will be covered and do not expect rescheduling to be completed before 1986. [redacted] 25X1

The regime attaches even less importance to repayment on $3 billion in trade arrears owed to Western export credit agencies (ECAs). While the ECAs 25X1

have organized under the Paris Club forum and officially required an IMF agreement as a precondition for rescheduling, Nigeria feels no pressure to reschedule this debt in the near term. Lagos has demonstrated its willingness to survive with reduced levels of trade credit, and probably has received conciliatory signals from individual ECAs in the last few months. Western press reports indicate that the French export credit agency may have participated in a recent Nigerian countertrade deal. [redacted] Such behavior encourages Nigeria's belief that it eventually can negotiate individual agreements without IMF compliance. [redacted]

In the near term, therefore, Nigeria will continue to lag on all trade debt rescheduling to ease its cashflow position because the cost of such intransigence—reduced levels of credit—is moderated by the desire of both official and commercial creditors to retain their market share in Nigeria. Although effectively barred from new medium- and long-term loans, Lagos still can meet its short-term borrowing requirements. In the absence of a credible threat to cut off short-term credit, we believe Nigeria has little incentive to alter its current policy on trade arrears. [redacted]

Boosting Oil Exports

Buhari has sought desperately to boost oil exports. Nigeria's ability to produce above its official OPEC quota of 1.3 million b/d is crucial—each additional 100,000 b/d is worth about $1 billion over 12 months. Nigeria began its export drive last year, when it secured OPEC's acquiescence to "temporarily" increase its quota to 1.45 million b/d. Nigerian production remained below this ceiling, however, until Lagos cut its official price $2 per barrel last October. Since then, Nigerian production has averaged about 1.6 million b/d. Even assuming the 300,000 b/d in overproduction carried some discounts from official prices, we estimate Nigeria has reaped an additional $2 billion by ignoring OPEC price and production guidelines. [redacted]

Buhari's oil policy has succeeded because OPEC has not established measures that would effectively penalize Nigerian transgressions. Last year's creation of an OPEC Ministerial Executive Council charged with monitoring members' production failed to deter overproduction. Nigeria, in fact, sits on the five-member council and issues periodic statements lamenting OPEC's lack of discipline. Beyond the absence of effective sanctions, Saudi Arabia's past willingness to reduce output actually has accommodated Nigerian overproduction. [redacted]

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Recent developments in the oil market, however, threaten Nigeria's efforts to boost export earnings. Overproduction by most other OPEC members, rising non-OPEC production, and flat worldwide demand have helped drive spot prices for Nigerian crude $2 per barrel below the official price of $28.65/bbl. At 1.6 million b/d, a change of $1 per barrel is worth about $600 million annually. Moreover, the British National Oil Corporation announced earlier this month that it would pay suppliers only $26.65/bbl for Brent North Sea crude—which competes directly with Nigerian crude. When Nigeria matched the British price cut of October 1984, Lagos announced its intention not to be undersold. Although Nigeria responded to the latest British price cut announcement by vowing to support OPEC's official price structure, in our judgment, Lagos will not honor this commitment if it results in a significant decline in sales. [redacted]

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Flourishing Countertrade

The scramble for customers in a weak oil market has spurred Nigeria's pursuit of countertrade agreements—bartering oil for food, raw materials, and other basic imports. The US Embassy reports that Lagos already has concluded $1.6 billion in countertrade deals covering 160,000 b/d in output, and is negotiating at least $2 billion in additional agreements. According to US Embassy reporting, Buhari sees countertrade as an important tool for securing long-term sales agreements despite its drawbacks of inefficiency, product limitation, and vulnerability to overpricing by suppliers. Lagos

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probably believes that countertrade also protects Nigeria from potential threats by creditors to cut off trade financing. At a minimum, unresolved trade arrears have not prevented official creditors—such as France, Italy, and Austria—from concluding countertrade agreements with Nigeria.

Fulfillment of countertrade goals could secure markets for about 400,000 b/d of oil if market conditions improve. To be beneficial, however, such deals must create new customers rather than merely displace existing sales. In our judgment, countertrade probably has helped Lagos maintain its above-quota production, but has not effected an overall increase in output. Moreover, a continued decline in spot oil prices could undermine existing agreements, which were struck at fixed prices. Although Nigeria's countertrade partners probably create an implicit discount by overpricing their products, a widening gap between contract and spot prices would make such deals uneconomic. 25X1

Outlook

Buhari's strategy of austerity, debt rescheduling delays, higher oil production, and countertrade requires, in our view, a firming of the oil market to enable Nigeria to survive another 12 months without the IMF. A decline in oil revenues below the 1984 level probably would create unsustainable foreign payments pressures requiring either a de facto default on some debt obligations or further reductions in imports. Faced with such options, whoever rules in Nigeria probably would be forced to seek an IMF agreement. 25X1

Even with a favorable oil market, however, Buhari's program makes no provisions for economic growth. Implementation of the structural adjustments necessary to restore growth would require new loans, and Nigeria's ability to reenter the long-term credit market hinges on an IMF agreement. The regime has endured the short-term costs of 25X1
rejecting the IMF, but eventually must reverse Nigeria's decline in income, employment, and manufacturing. As the pressures of economic stagnation mount, we believe Nigeria will have little alternative to reaching accommodation with the Fund. 25X1

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Kuwait: Coping With Recession

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Kuwait's economy is reeling from the sharp drop in oil revenues, the effect of the 1982 stock market crash, and the disruptive effects of the Iran-Iraq war. Although the recession has not seriously hurt most Kuwaitis, the public and the new National Assembly are increasingly critical of government efforts to deal with the situation. While some austerity has been undertaken, there is little public support for the hard-hitting measures needed to revitalize the economy. The attempt to assassinate the Amir on 25 May, however, is likely to increase public support for the ruling family and temporarily deflect attention from the economy. Barring a sharp drop in oil prices, Kuwait's leaders probably will muddle through and avoid serious threats to the regime by using the country's huge financial reserves to bail out failing companies and shield the population from the brunt of the economic problems.

Anatomy of a Recession

Since 1982, real nonoil GDP has stagnated compared with a 9 percent annual growth rate during the period 1975-80. Oil revenues—which account for roughly 80 percent of total export earnings—have fallen by half since 1979. Crude exports dropped last year to about 1 million b/d, compared with 2.4 million b/d in 1979. Several major customers—including Japan, Taiwan, and South Korea—who in the past purchased about two-thirds of Kuwait's crude oil exports, are now reluctant to renew their contracts.

The Iran-Iraq war is also cutting into foreign revenues. Prior to the war, reexports and shipping from Kuwait to Iran and Iraq brought more than $900 million annually into the Kuwaiti economy. Virtually all such shipments to Iran have stopped, and Iraq's financial troubles have resulted in an 85-percent drop in reexports to that market. In addition, attacks on Persian Gulf shipping have raised costs and inhibited maritime traffic in the region. Moreover, since 1980, Kuwait has contributed at least $8 billion in oil and cash to Iraq's war effort. 25X1

The economy still suffers from the effects of the 1982 collapse of the unofficial stock market (souk al-manakh). When the speculative bubble burst, nearly 6,000 investors saw their financial positions crumble. Banks were faced with huge writeoffs because of the liquidity crunch suffered by many borrowers and the plummeting value of collateral—mainly securities and land. Real estate firms were hard hit by the drop in property values and the depressed state of the local real estate market. Many firms were unable to meet their financial obligations, and, as opportunities for domestic investment dried up, capital flight increased. 25X1

Economic Stabilization

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The government responded to the drop in its revenues with a series of austerity measures. Overall expenditures leveled off after several years of rapid growth; development and construction spending dropped sharply, and foreign aid was slashed. Under fire from the National Assembly for a vast welfare system viewed as promoting wasteful consumption, the government doubled fuel prices, abandoned free school meals, and began assessing fees for some health services. The government, however, maintained defense spending at about $1 billion annually because of the threat posed by the Iran-Iraq war 25X1

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The government also attempted to prop up the value of shares on the official stock market and intervened to rescue failing companies. The government soon became the majority shareholder in more than half of the firms on the official stock market, prompting protests over what was seen as

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Kuwait: Current Account, 1980-85

Billion US $

	1980	1981	1982	1983	1984 [a]	1985 [b]
Trade balance	13.4	9.0	2.6	4.7	4.9	4.5
Exports (f.o.b.)	20.2	15.7	10.4	11.6	12.4	12.0
Oil	18.7	13.7	8.2	9.2	10.0	10.0
Nonoil	1.5	2.0	2.2	2.4	2.4	2.0
Imports (f.o.b.)	6.8	6.7	7.8	7.0	7.5	7.5
Net services	2.5	3.3	2.5	2.0	1.7	1.4
Freight and insurance	−1.0	−1.0	−1.1	−0.8	−0.9	−1.0
Investment income	5.2	5.7	6.0	5.5	5.4	5.3
Other	−1.8	−1.4	−2.4	−2.7	−2.8	−2.9
Grants	−0.9	−0.9	−1.0	−0.8	−0.5	−0.5
Current account balance	**15.0**	**11.4**	**4.1**	**5.8**	**6.1**	**5.4**

[a] Estimated.
[b] Projected.

[redacted] 25X1

wholesale nationalization. In April 1984 Kuwaiti officials announced a comprehensive package that included injecting $1.7 billion into the economy through investment companies to help liquidate traders' debts. Protectionist measures were also introduced—such as giving priority to local firms in contract awards—to revive the local economy. [redacted]

These policies, however, were inadequate. Bankruptcies continued because the government could not afford to bail everyone out. The protectionist policies were ineffectual because Kuwait's industries were not capable of replacing needed imports. The international financial community became increasingly alarmed about the situation and cut lending to nonbank institutions. [redacted]

Under growing domestic criticism, the government last fall created the Committee to Reactivate the Economy—a group of prominent public- and private-sector economic leaders—to devise remedies for the ailing economy. In March the Committee recommended creation of a duty-free zone, further protectionist measures, and establishment of a small business administration. To deal with the continuing effects of the stock market crash, it suggested the formation of a company to take over doubtful loans from commercial banks. These recommendations failed to gain public support, however, because most Kuwaitis do not accept the fact that such measures are necessary and blame government ineptitude for the country's economic problems. [redacted] 25X1 25X1

In April the government drafted a conservative budget for fiscal year 1985 (July-June) in which government spending is projected to decline 3.1 percent. Salaries for government workers are to be cut, and officials are attempting to justify a 15-percent drop in development spending by citing the near completion of many construction projects. [redacted] 25X1 25X1

Kuwait: Budget, 1982-85 [a] *Million US $*

	1982	1983	1984 [b]	1985 [c]
Revenue	11,055	10,472	10,756	10,626
Oil	10,231	9,612	9,708	9,592
Other	824	860	1,048	1,034
Expenditure	12,133	12,792	13,355	12,944
General	10,924	11,642	12,180	11,781
Recurrent	3,552	4,266	4,133	4,040
Development	2,252	2,416	2,966	2,773
Other	5,120	4,960	5,080	4,969
RFFG [d]	1,106	1,047	1,075	1,064
Increase in KFAED capital [e]	103	103	100	99
Deficit [f]	**1,078**	**2,320**	**2,599**	**2,318**

[a] Fiscal year beginning 1 July of stated year.
[b] Budgeted.
[c] Proposed.
[d] Reserved Fund for Future Generations.
[e] Kuwaiti Fund for Arab Economic Development.
[f] The deficits are covered by withdrawal from the State General Reserve Fund. Budget deficits are misleading, however, because transfers to the reserve funds are included in expenditures, but investment income is not included in revenues. In fact, Kuwait has enjoyed budget surpluses during the years cited above.

The Economy and the Elections

The government's handling of the economy was a major issue in the election for the National Assembly earlier this year. Candidates attacked the government for failing to respond to the slowdown in economic activity. During the campaign, prominent merchant families—who have been the ruling al-Sabah family's traditional base of support—charged that the government had not protected their interests. The Embassy reports that the Prime Minister and even the Amir himself were—at least privately—accused of poor judgment.

The election brought into office representatives who are more vocal and less cooperative than those in the previous National Assembly. According to Embassy and press reports, the Prime Minister had difficulty persuading several Assembly members to accept cabinet ministries, presumably because of their reluctance to be associated with the troubled government. Jassim Mohammed al-Khorafi, the new Minister of Finance and Economy, is expected to have a significant impact on economic policy. Khorafi—a sharp critic in the previous National Assembly of government economic policies—advocates subsidy cuts and curbs on luxury goods. Khorafi also wants to reexamine Kuwait's investment program, the impact of the 950,000 expatriate laborers on the economy, the burgeoning public sector, and the budget deficit. 25X1

Muddling Through

Kuwaitis continue to see the gloomy economic picture as a temporary phenomenon and refuse to acknowledge the need for long-term adjustment. Although Kuwait probably is better able to cope with the recession than any other Persian Gulf country—including Saudi Arabia—rising expectations may eventually clash with the reality of an economy that shows few signs of improvement. Although the government estimates that oil revenues will increase more than 5 percent annually during the next five years, we believe this is overly optimistic. Prospects for other revenue sources—industry, finance, and trade—are no brighter. Local investment is lagging, and we do not believe that the economy will improve until the war ends or the oil market firms up. 25X1 25X1

Bankruptcies of small, private businesses harmed directly or indirectly by the stock market crash probably will continue. The government is under considerable pressure to bail out these firms, but a decision has been put off. Kuwaiti officials are concerned about the cost—an estimated $2-5 billion, according to Embassy reporting—and are reluctant to acquire ownership of additional private companies. Nonetheless, the belief that the government will help is impeding settlement of the souk crisis. If the economy begins to deteriorate rapidly, however, the government probably will bail out many companies, maintaining ownership until the economy is back on its feet. 25X1 25X1

Kuwaitis Seek a Scapegoat

Sheikh Ali Khalifa, Oil Minister and chairman of the Kuwait Petroleum Corporation (KPC), has become the focus of the economic frustrations of many Kuwaitis. Finance Minister during the 18 months preceding the February elections, his handling of the souk crisis was blamed for many of the negative effects on the economy. Those who paid their debts in full soon after the crash resented Ali Khalifa for later allowing others to pay only a fraction of their debts. Many Kuwaitis were angry when he discontinued the government's policy of supporting prices on the official stock market, which resulted in a further decline in stock and land values. Ali Khalifa added to the disgruntlement of business leaders when he lectured them on sharing the burden of the economic slump [redacted]

[redacted]

[redacted] 25X6 25X1

Ali Khalifa reportedly has offered to resign, but, because he is a key player in the government and has international standing, the ruling family probably will put up a stiff fight to keep him. Still, the Embassy believes, and we concur, that Ali Khalifa is not untouchable. One critic, Hamad al-Ju'an, was earlier fired by Ali Khalifa from his job as Director-General of the Public Institution for Social Security. Now a member of the National Assembly, Hamad al-Ju'an now has a forum in which to air his views and attempt to exact revenge on Ali Khalifa. Should Ali Khalifa's critics persist, his fate could become a watershed for the current government. The National Assembly reportedly agreed to an al-Sabah family request that they tone down attacks on the cabinet, but US Embassy sources report that some Kuwaitis doubt that the understanding will hold. [redacted]

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Kuwait's small population and huge foreign reserves—over $70 billion—give the government room to maneuver. Officials, therefore, are unlikely to make cuts that would seriously hurt the population. Instead, the government probably will implement further protectionist measures and cut additional subsidies. For example, under the cover of the regional move toward uniform utility charges, Kuwait is considering trimming electricity and water subsidies. Khorafi also intends to transfer more public-sector facilities to the private sector to stimulate the market. Complaints about the size of the expatriate community—now 60 percent of the total Kuwaiti population—will increase; plans to cut their numbers have already been included in the new 1986-90 Five-Year Plan. Nevertheless, foreign aid, defense expenditures, and the General Reserve Fund [1] probably will be maintained at current levels. [redacted] 25X1

The Political Dimension

We do not believe that the economic problems facing Kuwait are regime threatening. Still, the

[1] Kuwait maintains two reserve funds: the General Reserve Fund (GRF) and the Reserve Fund for Future Generations (RFFG). The GRF receives income from loan repayments and investment income from assets held in this account. The RFFG was set up in 1976. By law the government must set aside at least 10 percent of public revenues for this fund, of which capital and investment income cannot be drawn upon until 2001. [redacted] 25X1

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public perception that the government mismanaged the souk crisis and the economy in general has hurt the ruling family. The new National Assembly has become bolder, forcing the resignation in May of Minister of Justice Shaikh Salman—a member of the ruling family—for corrupt handling of souk settlements. It also has called for the resignation of Oil Minister Shaikh Ali Khalifa. We expect the National Assembly to continue to test its powers, signaling a period of difficulty for the government and the royal family. The government probably will not attempt to suspend the Assembly, as it did in 1976, unless a serious confrontation develops, and even then it probably would promise new elections. Kuwait probably could absorb small price declines without seriously straining the economy, but if the price of oil were to plummet, the government would find it difficult to avoid making politically unpleasant budget cuts. The National Assembly probably would demand greater power sharing. If it feels that its power is threatened, the al-Sabah family may be forced into further accommodation with the National Assembly, broadening Kuwait's political base. [redacted] 25X1

The recent assassination attempt on the Amir will give the government a respite—if only a temporary one—from rising public criticism of the economy. Internal security will be the dominant issue before both the National Assembly and the ruling family in the near term. Meanwhile, Kuwait's economic problems will get short shrift and the troubles will continue to fester. [redacted] 25X1

[redacted] 25X1

Caribbean Windward Islands: Intractable Economic Problems [1]

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The economies of Dominica, St. Lucia, and St. Vincent and The Grenadines have yet to fully recover from natural disasters in 1979-80 and the global recession. We believe they will require generous infusions of aid indefinitely. We project that these economies, at best, will grow only 1 to 2 percent on average over the next few years, but only if the preferential UK market for bananas remains intact. Even then, their financial binds are likely to persist, unemployment pressures to mount, and public restiveness to grow. The United Kingdom, however—the island's major benefactor—appears to be weakening in its economic commitment to these ministates. Consequently, we expect pleas for stepped-up aid from the United States and increased pressure on Washington to prod other bilateral and multilateral donors to be more forthcoming.

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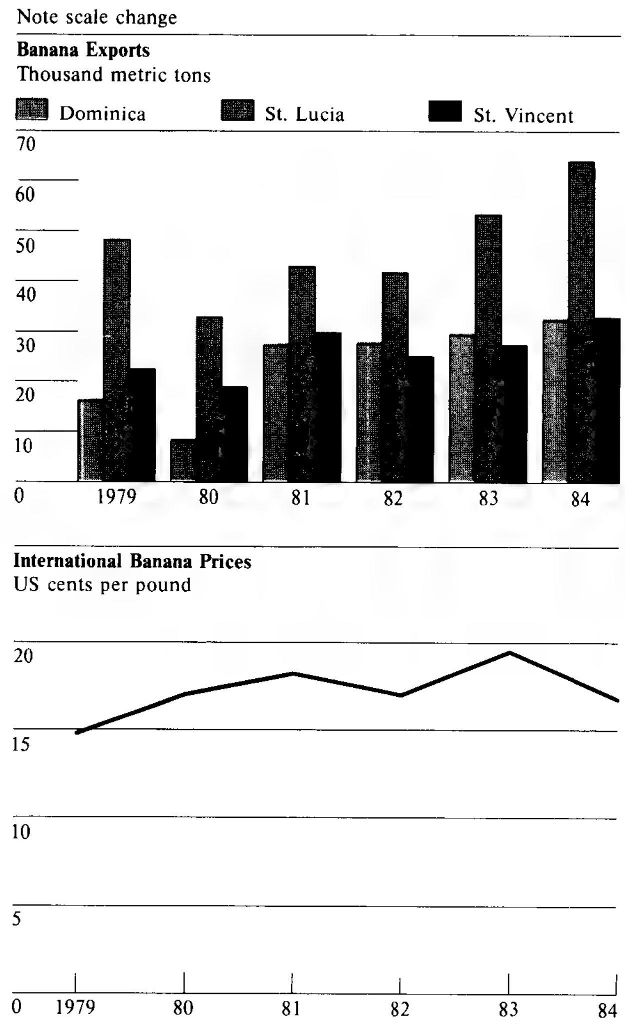
The Windward Islands: Banana Exports and International Prices, 1979-84



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Economic Realities

The Windward economies—dependent on bananas for as much as 70 percent of their foreign exchange earnings as well as nearly 25,000 jobs in a total population of only 330,000—have relied heavily on British largess for their economic viability. Without the protected British market, these islands could not sell their bananas. Moreover, British budgetary support and other Western aid have been vital; receipts from other foreign exchange earners—sugar, citrus, spices, and manufactures—have been erratic due to fluctuating international demand, stiff foreign competition, and domestic production difficulties. Even tourism—a major foreign exchange earner in much of the Caribbean—has provided sizable receipts only to St. Lucia.

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[1] The Windward Islands include Dominica, Grenada, St. Lucia, and St. Vincent and The Grenadines. This article excludes coverage of Grenada, however, because of its different economic and political problems in recent years

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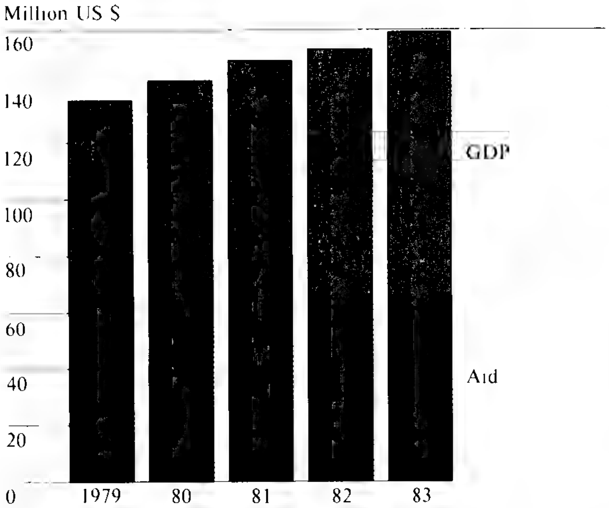
The Windward Islands: Western Aid Share of GDP, 1979-83[a]



[a] Includes British banana subsidy

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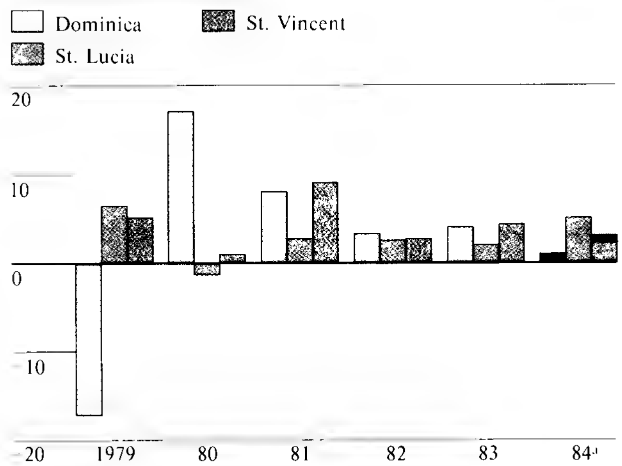
The Windward Islands: Real GDP Growth, 1979-84



[a] Shaded areas indicate a range.

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The Windward economies suffered severe disruptions during 1979-82 as a result of natural disasters and the worldwide recession:

- Dominica was battered by a 1979 hurricane that destroyed port facilities, industrial plants, roads, and crops. Real GDP fell 17 percent.

- St. Lucia, which had witnessed economic growth averaging 7 percent annually during the late 1970s, experienced a 2-percent drop in real GDP in 1980 after a hurricane destroyed much of the country's crops and tourist infrastructure.

- St. Vincent, hit by back-to-back disasters (a volcanic eruption in 1979 and a hurricane in 1980), saw agricultural output fall nearly 16 percent in 1979 and nearly 20 percent in 1980. Nevertheless, a spurt in foreign investment in light industry helped to prevent an overall economic decline.

Despite an influx of Western emergency and other aid, economic recovery in the three islands slowed during 1981-82 as the global recession depressed receipts from tropical products and tourism. 25X1

The worldwide economic recovery since 1982 has rekindled some economic growth, but serious foreign and domestic financial problems persist. Despite an overall increase in banana output, the weakness of the British pound—in which banana earnings are denominated—has reduced the islands' ability to import dollar-denominated goods. Other sectors have recovered even more slowly from recent setbacks. Moreover, high unemployment has made area governments especially reluctant to reduce their topheavy bureaucracies 25X1

Western Bilateral and Multilateral Official Development Assistance, 1978-83 [a]

Million US $

	1978	1979	1980	1981	1982	1983
Total	**24.6**	**40.9**	**37.6**	**40.8**	**32.8**	**26.7**
Dominica	16.1	15.5	15.0	20.9	19.5	14.5
Bilateral	13.6	6.9	6.0	6.6	9.0	10.1
United Kingdom	5.3	6.4	2.2	1.7	1.0	1.0
Multilateral	2.5	8.6	9.0	14.3	10.5	4.4
St. Lucia	2.8	11.7	11.5	10.4	8.0	6.5
Bilateral	0.9	11.3	1.7	3.4	3.8	1.9
United Kingdom	0.8	2.4	1.6	3.4	1.6	1.5
Multilateral	1.9	0.4	9.8	7.0	4.2	4.6
St. Vincent	5.7	13.7	1.1	9.5	5.3	5.7
Bilateral	3.8	13.3	1.3	2.5	1.1	1.1
United Kingdom	3.8	6.1	1.3	2.3	0.9	0.8
Multilateral	1.9	0.4	9.8	7.0	4.2	4.6

[a] Excluding $30-45 million annual banana subsidy from the United Kingdom.

Performance in 1984

We believe the economy of Dominica experienced little growth in 1984. Even with Prime Minister Eugenia Charles's determined effort to rebuild the banana industry, the island's rugged terrain, rudimentary transport network, small-size farms, and inefficient management hindered full recovery. Banana output rose 10 percent, but production remained well below prehurricane levels. Dominica's citrus industry also remained troubled by poor production techniques and inadequate use of fertilizer and other inputs. Coconut output, however, regained pre-1979 levels and provided inputs needed to bolster the island's small oil and soap industry. Worsening Caribbean Common Market (CARICOM) trade difficulties, nonetheless, limited overall sales from the 50 or so firms operating on the island.

The Windward Banana Industry

Geest Industries—currently the largest produce wholesaler in the United Kingdom and sole buyer of Caribbean fresh fruit for the British market—in 1953 pledged to buy every banana of export quality in the Windward Islands. The company also offered to market the Windwards' fruit and provide regular shipping. These countries later signed exclusive production contracts with Geest and shifted most of their agricultural exports from sugar and spices to bananas. By the mid-1960s, the Windward Islands supplied nearly 60 percent of the bananas sold in the UK market displacing Jamaica, Cameroon, and the Canary Islands as the main suppliers. 25X1

Under the Geest arrangement, the United Kingdom provides substantial financial assistance—as much as $45 million annually—to the islands by guaranteeing a cash market throughout the year. In addition, during hard times—hurricanes and droughts—the United Kingdom supports prices and lowers shipping and distribution costs through Geest. Recent low production from the islands, however, has prompted the British to purchase increasing amounts of "dollar market" bananas primarily from South and Central America.[a] *These countries face hefty duties in the UK market, but lower wages, higher productivity, and better quality allow them to compete effectively with protected suppliers.* 25X1 25X1

The Eastern Caribbean's preferential market, however, may be in jeopardy. US Embassy reporting from Bridgetown indicates that Geest's monopoly is being challenged by a small British importer in the UK courts and the European Court of Justice. We believe the elimination of the Geest monopoly would virtually destroy the Windward banana industry. 25X1

[a] *In 1978 the Windward Islands held a 60-percent share of the British banana market, with 200,000 metric tons of exports. Although there has been some recovery from the natural disasters of 1979-80, the Islands' share of the British market last year still was only 30 percent with exports of only 130,000 tons.* 25X1

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Unlike the other Windward Islands, Dominica made some headway in alleviating foreign payments problems last year. Despite a doubling of the trade deficit due to reduced intraregional trade and low banana receipts, the combination of IMF lending and US aid helped to push the country's foreign payments position into the black for the first time since the late 1970s. The influx of funds—designed to rebuild roads, electrify rural villages, improve airport facilities, and upgrade the banana industry—created some jobs. Unemployment still exceeded 20 percent.

St. Lucia's economy rebounded in 1984—real GDP increased 5 percent, according to the Eastern Caribbean Central Bank—as banana production increased 20 percent to a record level and tourism rivaled the heyday of the late 1970s. An improved political climate under Prime Minister John Compton and better promotional efforts by the government enabled St. Lucia to increase tourism by 15 percent over 1983. Output gains in the 70 or so manufacturing companies operating on the island also buoyed economic growth.

St. Lucia nonetheless faced worsening unemployment, rampant poverty—especially in the capital city, Castries—and severe domestic payments difficulties. According to the US Embassy in Bridgetown, reduced emigration opportunities elsewhere in the Caribbean helped to push the island's unemployment rate to nearly 30 percent.

We believe St. Vincent experienced only a 2 to 3 percent increase in real GDP last year. The weak British pound limited revenue gains from the 20-percent increase in banana output at a time when other foreign exchange earners encountered difficulties. Most of the arrowroot crop, for example, went unsold because of increased competition from lower cost, starch sources elsewhere. Production of sugar, coconut, and nutmeg also languished. Tourism, viable only in The Grenadines, grew only slightly because of the island's remote location, poor air links, and negligible advertising. Stymied by periodic electricity blackouts and other infrastructural weaknesses, as well as a small local market, light industrial growth slowed considerably.

St. Vincent also faced especially severe financial deficits and unemployment pressures. Prime Minister James Mitchell, elected in July 1984, inherited large domestic and foreign financial shortfalls that he blamed on the previous Cato government's heavy subsidies to the sugar, shipping, and tourist industries. Publicly rejecting pursuit of an IMF program, Mitchell appointed a commission to assess the country's economic situation but otherwise moved slowly in implementing new economic policies. Meanwhile, Embassy Bridgetown reports unemployment reached a record 40 to 50 percent. 25X1

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Dim Outlook

We believe these countries' ability to help themselves through economic diversification will be sharply limited over the foreseeable future. Their small market size, inefficient regional and extra-regional transport, paucity of skilled labor and managerial talent, and lack of infrastructure needed to attract investment—even under the Caribbean Basin Initiative (CBI)—will remain constraints not easily overcome. 25X1 Moreover, rising protectionist sentiments in the Caribbean and some new US regulations will complicate external fixes. For example, a number of East Asian producers—bumping against US quotas on textile imports—have considered opening finishing operations in the Windward Islands to circumvent quotas. 25X1 We believe new US rules-of-origin regulations, however, will discourage these potential investors. 25X1

We judge that these economies will, at best, record only 1 to 2 percent economic growth on average over the next few years. As long as the British pound remains weak, banana earnings in dollar terms will not expand proportionately. Weak world demand for the islands' other major tropical products will preclude much, if any, increase in receipts from this source. Intractable problems in the manufacturing sector also will limit sales of finished products. The tourist sector can be expected to hold promise only in St. Lucia. 25X1

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Island standards of living, therefore, are likely to further deteriorate and to trigger sporadic unrest. [redacted] bur-geoning unemployment and deteriorating economic conditions could eventually trigger political unrest that leftist elements would try to exploit. In Dominica, Charles is favored to win the 1 July elections but is unlikely to repeat her 1980 landslide because the left-leaning opposition already is capitalizing on the country's stalled recovery. [redacted] 25X1

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Consequently, we believe these governments will increasingly look to the United States for direct and indirect support to help make financial ends meet and ensure political stability, particularly if London's financial commitment weakens. Government leaders in St. Lucia and St. Vincent have publicly advocated joint ventures with large US firms to overcome their countries' financial strains. Moreover, Charles recently called on the IMF to set up a trust fund to help Caribbean ministates overcome long-term structural difficulties. [redacted] 25X1

[redacted] 25X1

Briefs

Energy

OPEC Production Update

OPEC crude oil output in May averaged 15.1 million b/d, 900,000 b/d below the organization's production ceiling. A steep falloff in liftings by the former Aramco partners caused output in Saudi Arabia to fall to an 18-year low. Oil market expectations of a possible cut in OPEC's official prices deterred buyers. [redacted] 25X1

[redacted]

OPEC: Crude Oil Production, 1985 *Million b/d*

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	Quota	First Quarter	April	May
Total	**16.00**	**16.5**	**16.5**	**15.1**
Algeria	0.66	0.7	0.7	0.7
Ecuador	0.18	0.3	0.3	0.3
Gabon	0.14	0.2	0.2	0.2
Indonesia	1.19	1.3	1.3	1.3
Iran	2.30	2.2	2.7	2.5
Iraq	1.20	1.2	1.3	1.3
Kuwait [a]	0.90	1.2	1.0	1.0
Less share of Neutral Zone		0.9	0.8	0.8
Libya	0.99	1.0	1.0	1.0
Nigeria	1.30	1.6	1.6	1.4
Qatar	0.28	0.3	0.3	0.3
Saudi Arabia [a]	4.35	3.8	3.6	2.7
Less share of Neutral Zone		3.6	3.4	2.5
UAE	0.95	1.2	1.2	1.2
Venezuela	1.56	1.6	1.5	1.5

[a] Neutral Zone has no production quota; output is divided between Saudi Arabia and Kuwait and included in their country quotas.

[redacted] 25X1

Oil Consumption Decline

Oil consumption in the major industrialized countries is trending down. First-quarter oil sales were 1 to 2 percent below year-earlier levels. Even before UK consumption fell in response to an end to the coal strike, consumption was slipping faster than most market analysts had expected. Partial data for the second quarter indicate the decline is accelerating. April consumption in the United States, Japan, West Germany, France, Italy, and the United Kingdom was about 4 percent below year-earlier levels. Preliminary figures indicate US consumption fell by 4 to 5 percent in May. Heavy fuel oil demand is bearing the brunt of the decline—consumption in the major markets, excluding the United Kingdom, in the first quarter was 15 to 20 percent below year-earlier levels. Substitution of natural gas, coal, and nuclear energy was largely responsible. OPEC will have difficulty holding the line on prices if oil consumption continues falling. 25X1

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Oil Inventory Levels

Weak oil consumption has caused an inadvertent inventory build in recent months. We estimate non-Communist primary oil stocks at the end of March stood at 3.9 billion barrels, almost 90 days of consumption. Government-owned stocks account for about 600 million barrels or 14 days supply. Preliminary second-quarter consumption and production data suggest oil inventories may climb faster than expected—perhaps by 1 million b/d or more—and leave inventories at midyear about 100-200 million barrels above planned levels. Expectations of lower oil prices will encourage oil companies to pare excess inventories in the coming months. This inventory adjustment process will hold down demand for OPEC oil this summer and further exacerbate downward price pressures. 25X1

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Mexican Oil Price Cut

Plummeting oil export volume prompted Mexico this week to reduce the price of its heavy Maya crude $1.50 a barrel retroactive to 1 June. The state oil company also said it will postpone action on its lighter Isthmus crude until after the next OPEC meeting in early July. Mexico probably acted because oil revenues have dropped an estimated $1 billion from the corresponding 1984 period. Losses were particularly heavy in June when customers, anticipating another round of OPEC price cuts in July, reduced their planned liftings by almost 50 percent to 800,000 b/d, according to the US Embassy. With its serious budget and external payments problems, Mexico was unwilling to sustain such losses for long. Given the weak world oil market, Mexico may not be able to fully restore lost oil export volume, even with the announced price cut. 25X1

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Thai-Japanese Natural Gas Project

A new Thai-Japanese joint venture has been formed to promote a liquefied natural gas (LNG) marketing and export project in Thailand. The Thai LNG Company and a Japanese consortium of Mitsui, Mitsubishi, Sumitomo, and Marubeni have created the Thai International LNG Company to determine the feasibility of exporting about 4.3 billion cubic meters of LNG annually to Japan for 15 to 20 years beginning in 1989 or 1990, according to the Japanese

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press. This amount would cover about 7.5 percent of Japanese LNG demand in the 1990s. Tokyo already has sufficient supplies tentatively lined up to meet about three-fourths of its natural gas requirements through 2000. The future of the project will depend on sufficient gas discoveries to justify the capital costs, resolution of a dispute over legal title to the gas, Thai Government support in the face of budget austerity, and commitments from Japanese utilities, many of whom have little expected need for the gas. [redacted] 25X1

India Revises Major Gas Pipeline Project

New Delhi reportedly plans to invite new foreign bids early next month for a 1,730 kilometer pipeline system to bring gas from offshore fields to fertilizer plants that will be constructed in western and central India. The decision to restructure this project—superseding bids received a year ago for various parts of the project—has prompted severe criticism from opposition political parties and Indian industrial analysts. The delay probably will raise total costs well above the original estimate of $1.7 billion. Indian suppliers of equipment and public-sector consultants fear that they will now lose out to a consortium 25X1 headed by Snamprogetti, an Italian firm whose aggressive local representative is said to be close to Prime Minister Gandhi's Italian-born wife. New Delhi probably hopes to obtain substantial additional financing from the successful bidder. In addition, contracting for a complete system will ease the managerial task for India's inexperienced government agencies. [redacted] 25X1

Iraqi-Saudi Pipeline Construction

The US Embassy in Riyadh [redacted] indicate that the Saudi 25X1 portion of the Iraqi pipeline that will connect with Saudi Arabia's Petroline is being built on schedule and could be commissioned by early October. [redacted] 25X1 [redacted] several problems, primarily involving the Iraqi 25X1 section, could delay the line's opening. [redacted] 25X1 construction on Phase II of the project—to increase the line's export capacity to 1.5 million barrels per day—could begin before the end of the year. 25X1 Baghdad hopes to sell crude from the pipeline to Japanese firms, but [redacted] the Japanese are hesitant to buy without significant price incentives. 25X1 The pipeline probably will not be able to operate at its designed capacity of 500,000 b/d before December, but Iraq, beset by financial troubles, is pushing 25X1 hard to complete work on schedule. Baghdad has been pricing its oil competitively and probably will sell oil from the new pipeline at discounted prices. [redacted] 25X1

International Finance

Nicaraguan Debt Deferral

Some 100 commercial banks—including 60 US institutions—signed an agreement this week to postpone about $300 million in Nicaraguan debt payments for one year. About half of this is owed to the US banks. [redacted] 25X1 [redacted] Nicaragua's economic performance is so poor that creditors did not 25X1 even try to devise a multiyear rescheduling. The agreement includes approximately $200 million in arrears and another $100 million coming due during the next 12 months. Bankers agreed to token repayments of about $24 million

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by next June, when the balance will fall due. Managua will be hard pressed to meet even the token payments because its export earnings are down sharply, and the US embargo is increasing financial pressures. Nonetheless, banks had little alternative but to agree to Nicaragua's terms. Many apparently have already written off their Nicaraguan loans but probably hope to cut their losses. The agreement technically eliminates arrearages and will help Managua negotiate with the IMF and the World Bank. 25X1

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Moroccan-IMF Compromise

Morocco and the IMF resolved the impasse on subsidy reduction's last week removing the primary obstacle to Fund approval of a new standby package. The IMF accepted Rabat's argument that significant cuts in food subsidies would cause national unrest. In return, the government agreed to hold subsidy costs to $210 million this year and compensate for the expected $70 million in above-budget spending by delaying the 5-percent pay raise for civil servants scheduled for July. Moroccan officials also hope to sign the long delayed 1983-84 commercial debt rescheduling agreement by 25 June—the final obstacle to the IMF package—which would pave the way for a rescheduling next month of Morocco's official debt for 1985. The new IMF money will provide badly needed funds and vote of confidence for Morocco's economic stabilization package. Nevertheless, the IMF program could come unravelled quickly if, as is likely, Rabat does not sign the commercial rescheduling agreement or cannot accommodate spending limits specified by the Fund. 25X1

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Zairian Problems in Meeting IMF Targets

Zaire must bring its budget in line with IMF performance targets by next week or risk jeopardizing its current standby arrangement, recent debt rescheduling with Western governments, and improved image in the international financial community, according to the US Embassy. Excessive borrowing—primarily because of lower-than-expected oil and custom receipts—caused Kinshasa to fail its last IMF review in March. President Mobutu has shown unusual perseverance since 1983 in implementing IMF-supported austerity measures but appears increasingly frustrated with the severity of the IMF stabilization program. Moreover, opposition to the austerity measures recently surfaced at a Central Committee meeting and popular discontent with the economic stabilization program appears to be growing. Fifty percent of the

25X1

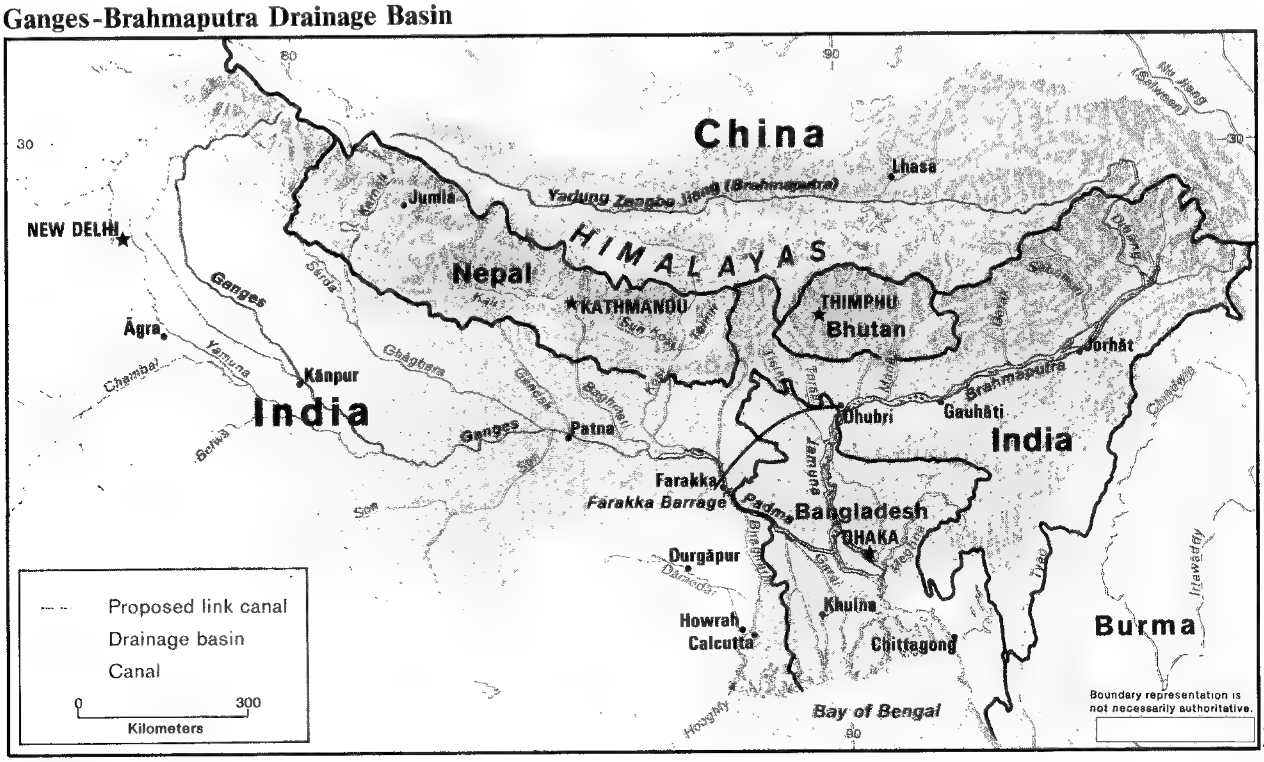
budget goes to debt servicing, leaving little for deteriorating transportation, communications, health, and education sectors. The government has made little headway in boosting agricultural production or in restructuring money-losing state enterprises. Mobutu will find it increasingly difficult to meet IMF targets during the remainder of 1985, particularly as he comes under increasing pressure to implement promised development programs. Mobutu is likely to mount an aggressive campaign to convince the IMF and Western donors of the political necessity for a more expansionary budget and increased levels of assistance. 25X1

Global and Regional Developments

Indian-Bangladesh Water Problems Persist

The latest round of talks between India and Bangladesh on water sharing has concluded without agreement. Dhaka asserts that India's increased offtake of the Ganges River has decreased the river's flow into Bangladesh during the spring dry season and that Bangladesh should be guaranteed a minimum water supply. New Delhi has linked water sharing with the construction of a canal that would augment the Ganges with water from the Brahmaputra River. Dhaka has rejected this proposal because the canal would displace about 200,000 people in northwest Bangladesh. Dhaka was particularly disappointed with the outcome of the recent talks because it believed that Prime Minister 25X1

Ganges-Brahmaputra Drainage Basin



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Gandhi had promised that an agreement would be concluded. Bangladesh will probably press for further negotiations because its agricultural sector depends on the rivers entering from India. [redacted] 25X1

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[redacted]

Reaction to US Export PIK

[redacted]

The three-year, $2 billion payment in kind subsidy program to increase US agricultural exports--known as export PIK--has prompted critical but cautious responses from other exporters. EC reaction remains guarded. [redacted] 25X1
Embassy reports, no retaliation is planned as yet, although options being discussed by the Commission include restructions on imports of US grain, expanded EC wheat exports, and a call for an emergency meeting in the GATT. The Australians fear US/EC confrontation could stimulate more aggressive EC sales in Australia's traditional markets. New Zealand press reports reveal concern about the vulnerability of its Middle Eastern dairy markets to potential subsidized US dairy sales. [redacted] 25X1 25X1 25X1 25X1
Brazil sees its poultry and soy markets threatened, and will lobby for exemption of soy products from the export PIK program. Although the impact of export PIK on foreign country agricultural programs is uncertain, any sizable drop in world grain prices could seriously harm debtor LDCs such as Argentina and Brazil who depend heavily on agricultural exports. Lower grain prices could also boost the EC's own export subsidy outlays. Moreover, any EC sales lost to the United States as a result of export PIK are likely to be offset by sales in the markets of the other exporter countries. Foreign reaction to export PIK is also likely to divert attention from planning for a new GATT round and to polarize agricultural subsidy discussions in GATT. [redacted] 25X1

National Developments

Developed Countries

Japanese GNP Growth Slows

Release of first quarter GNP statistics—revealing that quarterly growth hit a seven-year low of 0.1 percent—may spark renewed calls for Tokyo to adopt stimulative economic policies. Officials at the Economic Planning Agency,

however, insist the latest data reflect the unsustainability of the rapid growth recorded in October-December 1984 rather than stagnant economic conditions. Moreover, they point out Japan achieved 5.7-percent growth for the fiscal year ending in March, the best performance in 12 years. [redacted] 25X1

[redacted]

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[redacted]

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Decline in UK Arms Sales

The United Kingdom exported 825 million pounds ($990 million) worth of arms in 1984, according to attache reporting. The 1984 sales were down about 10 percent from 1983 levels, largely because exports to the Middle East—Britain's most important market—were down 38 percent. Although arms sales typically vary from year to year, we believe that the 1984 total reflects a long-term decline for British sales. Worldwide arms demand is declining, and competition to make sales has sharpened. Financial competition has become particularly rough, because sales to Third World clients frequently go to those offering the best financial package. Britain's economic troubles and outmoded arms-financing system, however, have left it ill equipped to compete in this environment. Moreover, Britain's lack of a high-quality sales leader—such as France's Mirage 2000—has hurt its competitiveness. Over the long term, declining overseas sales will increase the unit costs of systems purchased by UK forces, thus reducing the numbers that are affordable and decreasing the effectiveness of British forces. [redacted]

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UK-Italian Attack Helicopter for the 1990s

The major helicopter companies of Britain and Italy, Westland and Agusta, are planning to jointly develop a new attack helicopter for the 1990s. The United Kingdom will buy at least 125 of these helicopters; Italy will buy a minimum of 60. We believe the combined purchase will be worth about $1 billion. In the export market, this new design will compete with the Franco-German Eurocopter, a joint program of Aerospatiale and Messerschmitt-Boelkow-Blohm, as well as the US Bell AH-1 Cobra and the new Hughes AH-64 Apache. [redacted]

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West German State Government Supporting High Tech

[redacted]

The Bavarian Government has decided to actively encourage the continued concentration of high-tech electronics firms in southern West Germany. The decision was prompted by a study indicating that the already heavy concentration of international electronics firms in and around Munich, the Bavarian capital, had reached a self-sustaining level that should promote further rapid expansion of the industry. The study also concluded that electronics had become Bavaria's largest industry and had added 10,000 jobs to the Bavarian economy in the last few years. Bavaria, West Germany's second most populous state, will allot about $15 million during 1985-88 to promote microelectronics, which will complement generous federal-level promotional programs. Bavaria hopes to create at least 20,000 additional jobs in microelectronics in the next few years, catch up with the United States and Japan in this field, and become more independent of US-controlled technology. [redacted]

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Belgian Stress Over COCOM Restrictions

[redacted]

Belgian Foreign Minister Tindemans is concerned that another dispute with Washington over technology transfer will hurt his political standing and help the Socialist opposition before the general election in December. According to the US Ambassador, Tindemans fears that if Washington refuses to allow a Belgian firm to supply controlled communications equipment to China the firm will lose a valuable contract and that broader economic relations with the Chinese will be damaged. Tindemans says the Belgians believe that French and other suppliers will fill the vacuum despite their promises to refrain. Belgium has been forced to pull back on a number of deals involving sensitive technology over the past year, including a nuclear cooperation agreement with Libya. The Belgian firm involved is located in Tindemans's home district, and, if it were to lose the Chinese contract, several thousand people might lose their jobs. Belgium unemployment is more than 13 percent. Tindemans's opponents have scored his support for US constraints on technology transfer, and he apparently expects Washington to do what it can to help him domestically.

[redacted]

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Spanish Export Controls

[redacted]

Madrid has introduced controls on exports of dual-use technology to prevent diversion to Communist countries. High-technology products manufactured under foreign licenses or with foreign investment in Spain are covered, but imports worth less than 1 million pesetas—about $5,700—imports by public-sector enterprises, and goods transiting free trade zones are exempt. Prime Minister Gonzalez has publicly indicated that he favors eventually joining COCOM rather than negotiating bilateral agreements to bring Spain's export control program into alignment with EC policy, but the Cabinet remains divided. The Spanish are establishing their own controls in the hope that the United States will grant pending export licenses for products that are important to Madrid's electronics development plan. The exempt categories are likely to create problems, but Spain probably will agree to meet exporting countries' requirements rather than risk denials. [redacted]

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Less Developed Countries

Venezuela's Aluminum Expansion

Industry problems in Jamaica and Suriname—excess capacity, losses, and closures—have not deterred Caracas from expanding its aluminum-export capacity. Cheap hydroelectric power and the recent discovery and exploitation of high-grade bauxite reserves give Venezuela a strong competitive edge. Reporting indicates that Venezuelan state aluminum companies will spend $1.3 billion to increase capacity from 340,000 to over 800,000 metric tons per year by 1988, and will produce bauxite, alumina, ingots, and finished products. Japan's recent multiyear contract to buy 160,000 tons per year strengthens Venezuela's role as an aluminum exporter and will reduce Caracas's dependence on oil sales. [redacted] 25X1 25X1

Setbacks for Jamaica's Alumina Industry

The manager of the financially troubled ALPART alumina refinery, the largest US investment in Jamaica, has told the US Embassy that the company may close the plant this month. The manager of the Canadian-owned ALCAN refinery has indicated that his company will close one of its two plants soon unless Kingston provides substantial tax relief. ALCOA's refinery was shut down in February, but it is to reopen in July under a lease arrangement with the government that will earn Jamaica little foreign exchange. These closures would further depress the Jamaican economy. The IMF is already projecting bauxite earnings at $140-230 million less than last year and that the loss would contribute to a 4-percent decline in the economy this year. The latest developments could slow ratification of the $60 million Fund standby program, slated for approval in mid-July, and subsequent debt reschedulings. The closure of ALPART alone would cost 1,200 jobs, adding to the 30-percent unemployment rate. [redacted] 25X1 25X1

Libyan Water Project Prioritized

[redacted] Qadhafi has pulled out all stops to complete the water-supply system for the Marsa al Burayqah pipe plant—a key element of the Great Manmade River Project—in time for the 1 September anniversary of his military coup. Qadhafi plans to inaugurate this system personally to emphasize the feasibility of the huge water-relocation project. Overall, the scheme is running up to six months behind schedule because of management problems and minefields that date from World War II. Financial outlays are below budget [redacted] because of the construction delays. Qadhafi almost certainly will use the inauguration of the pipeline segment to tout the participation of US firms in the project and to demonstrate that US economic sanctions have not hindered the regime's ability to pursue large-scale development. [redacted] 25X1 25X1 25X1 25X1

Tunisian Subsidies Cut

Tunis raised retail fuel prices by 10 percent and producer sugar prices by 24 percent last week and linked future price adjustments to wage hikes. The US Embassy says that the newest round of price hikes—the first since January—have elicited little more than grumbling from consumers. The full impact,

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however, will not be realized for several months. Should the government give way to labor demands for higher wages, it is prepared to implement equivalent across-the-board price increases to neutralize the impact on the budget. This newest cost-containing measure underscores the difficult task the regime faces in balancing its policies on wages and consumer subsidies without further alienating the poor who rioted over food prices in January 1984. 25X1

Malawi Bumper Crop Face Export Problems

Malawi faces a serious economic crisis unless it can find new customers for this year's bumper crop of corn, tobacco, and cotton. The large yields reflect the response of small farmers to price incentives under a World Bank reform program. The state-owned purchasing and marketing board, however, has been unable to market the large harvest because of a lack of grain export contracts—Zambia has canceled grain purchases—heavy financing requirements for carryover corn stocks, and complete exhaustion of all commercial borrowing facilities. The Reserve Bank of Malawi is reluctant to extend emergency loans that would violate Malawi's credit agreements with the IMF. 25X1
Although Malawi has served as a regional granary for drought-stricken neighbors for the past two years, those countries either do not need, or cannot afford, substantial amounts and Malawi's only alternative may be to rely on purchases by international relief agencies. 25X1

Pakistani Assembly Approves Budget

Pakistan's National Assembly approved the proposed budget for fiscal year 1985, which begins 1 July, with only minor changes. Expenditures are projected to grow by about 14 percent and revenues by about 15 percent. The government hopes to cover its growing resource gap by attracting more than $1 billion into small savers schemes. We believe this budget will follow the pattern of previous years. Expenditures will exceed budgeted levels and revenues will fail to reach projected levels, requiring additional government borrowing. The budget—the first major issue on the new assembly's agenda— 25X1
does not include any major new taxes or other contentious reforms. Assembly members scored their first victory—which expedited approval—when the government agreed to withdraw a surcharge on diesel fuel and reduce the proposed increased in railway fares. The powerful agricultural lobby was appeased with additional benefits and subsidies. These concessions came at the expense of planned development expenditures. 25X1

Sri Lanka Seeking More Western Aid

Finance Minister De Mel, on his way to meet with Western aid donors this week, is likely to paint a bleak picture of the Sri Lankan economy. The unfavorable economic outlook puts added pressure on the Jayewardene administration to negotiate an end to the ethnic violence. In a speech to civil servants in Colombo, De Mel noted that, unless the insurgency is halted, the country will face economic disaster within six months. Tourism and foreign investment continue to decline, and economic activity in the north and east have been severely disrupted. Since the beginning of the year, tea prices have 25X1
dropped 30 percent from record highs—tea accounted for over 40 percent of export earnings in 1984. Meanwhile, defense costs have more than tripled

since 1982 and continue to rise, adding to budget deficits and slowing development efforts. Nonetheless, De Mel probably will exaggerate the economic problems in his effort to sustain high aid commitments. [redacted] 25X1

Nauru Faces Economic Decline

The government of the South Pacific ministate has borrowed heavily abroad rather than impose taxes or restrict imports [redacted] and 25X1 debt service has risen to 50 percent of export earnings. Phosphate sales—the sole source of government revenue—are stagnant, and despite its deteriorating credit rating, the government is not taking measures to reverse the economic slide, such as developing a fishing industry—the only other significant resource. At the same time, the government's investment ventures—an airline, 25X1 a trade corporation, overseas investments, fishing vessels, and hotels—have lost money. Although divestiture would temporarily ease the problem, the island's decline is likely to continue to worry Australia and New Zealand, which are trying to turn back Soviet initiaties among economically depressed ministates in the region. [redacted] 25X1

Communist

Soviet Consumer Goods Production

Although Moscow reportedly intends to take "effective measures to increase production and imports of consumer goods," resource constraints will make this difficult to accomplish. A Soviet economist has told the US Embassy that pay incentives for the introduction of new technology—a key element in General Secretary Gorbachev's industrial modernization strategy—would be ineffective without a similar increase in the supply of high-quality consumer goods. Moscow has announced an almost $8 billion program to increase shoe production, and action to increase supplies of consumer durables and building materials should soon follow. To implement these projects, the source said, 25X1 both domestic resources and imports will be used. Because of poor quality, imports of CEMA products will be cut and hard currency purchases from the West increased. [redacted] 25X1

Gorbachev has personally identified himself with an increased commitment to consumer goods. Increased investment, however, is necessary, but funds already committed to other sectors will leave little for the consumer. A high-ranking planning official recently acknowledged that problems will continue in the consumer sector and few additional resources will be made available to overcome them. Large-scale imports of Western grain and an expected increase in plant and machinery imports will also squeeze the availability of hard currency for consumer goods. [redacted] 25X1

Soviets Seek US Plywood Processing Plant

The Minister of the Timber, Pulp and Paper, and Wood Processing Industry indicated in late April that the USSR wants to buy a complete plywood processing plant from the United States. He will visit US firms this summer to discuss the turnkey project. The plant is connected with negotiations for the purchase of plywood processing machinery for existing plywood mills. This

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equipment and the completion of the proposed plant would do much to modernize the forest products industry. In addition to this latest project, the Soviets are planning to buy a US pulp and paper plant for corrugated box production, a pulp-dissolving plant from US and Italian firms, and an Italian hardwood pulp and cellulose plant. The total value of these projects exceeds $1billion. 25X1

New Vietnamese Measures To Slow Population Growth

Hanoi over the past year has begun implementing a program of disincentives to slow population growth—2.4 percent, one of the highest in Southeast Asia. Penalties for violating the new limits of two children for government employees and urban workers and three children for rural residents include reduced housing and food subsidies, reduced maternity benefits, loss of government jobs, and possible loss of Communist party membership. 25X1
Hanoi is moving slowly, however, apparently introducing the 25X1
program on a province-by-province basis. We believe the disincentives will have to be strengthened and applied to major cities if Vietnam is to succeed in 25X1
slowing population growth sufficiently to keep pace with food supply.
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